No. 96-1592

Supreme Court, U.S.
FILED
MAY 14 1997
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

MARILYN OLKEY, *et al*,

Petitioners,

—v.—

HYPERION 1999 TERM TRUST, INC., *et al*,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITIONER'S REPLY IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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The second circuit's opinion announced a new legal principle in an area that is being and will be litigated dozens of times each year (Pet. at 10-11).[1] The area involves the financial interests of tens of thousands of people. The law of this case will determine the extent to which sellers of securities into the public marketplace may be immunized from liability by the making of generalized, allegedly "implicit" statements that warn of risks to be sure, but not of the risks associated with what's actually being sold. Moreover, the generalized risk disclosures herein were decreed to carry weight equal to numerous, precise, and explicit representations concerning what purportedly is being sold.

> "[Plaintiffs] offer no serious rationale as to why a reasonable investor who was reading the prospectuses would consider the warnings too generic to be taken seriously and, at the same time, would find the sections discussing the opportunities and protections enticingly specific",

wrote the court (App. 16a). The answer is that the latter were anchored to the represented characteristics of the investment; the former not. By its decision the second circuit has parted company with seven other circuits who, together with the chief judge of the second circuit in his dissent, have held, repeatedly, that generalized or untailored disclaimers offer no safe harbor.

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[1] "Pet." refers to the petition herein.

The second circuit's opinion, in the words of Chief Judge Newman, also was reached "before any evidence has been presented [and] is contrary to Rule 12(b)(6)(vi) [and thus 7th Amendment] standards." App. 22a. The chief judge and other commentators have equally criticized the decision, noting among other things that,

> "What distinguishes *Olkey*, however, and what makes this decision potentially devastating to securities fraud plaintiffs is the Court's willingness to speculate what 'must have been' or 'should have been' in minds of investors based on its own reading of prospectus and related materials -- and to make such 'findings' without a single deposition having been conducted."

Pet. at 17-19; App. 23a. With arbitrary strokes of the pen and lip service obeisance to what reasonable people might have in mind, the court destroyed the Seventh Amendment rights of thousands of investors. It is difficult to conjure up a more arbitrary extension of the limited fact-finding authority provided by rule 12(b) than the majority's predicate proposition that reasonable people assume great risks for small returns. Pet. 8, 18-19; App. 18a. Read this, for there is almost no need to read more than this. "Since a reasonable investor could have found the promise of moderate returns attractive despite the risk of substantial losses, there is no reason to dismiss the extensive and detailed cautionary language of the prospectuses as boilerplate" (App. 18a). Pull this linchpin, and the decision falls.

Respondents try to diminish the importance of the clear legal issues at stake under a minutiae of extracts, largely extra-contextual, from the offering materials. It is what they do not say, however, that reveals the legal issues and their compelling nature that are now presented to the court. We turn to those now.

I. THE SECOND CIRCUIT HAS CREATED A NEW RULE THAT WILL EVISCERATE THE FEDERAL SECURITIES LAWS AND THAT IS AT ODDS WITH AN UNBROKEN LINE OF AUTHORITIES OF SEVEN OTHER CIRCUITS.

Nowhere in respondents' briefs does either make any contact with the following indisputable, uncontroverted points.

1. The prospectuses represented, baldly, that the defendants' investment advisor

> "*has designed* the initial composition of the Trusts' portfolio[s], and will manage the portfolio[s] on an ongoing basis in an attempt to minimize the impact of changes in interest rates on the net asset value of the portfolio[s]"

App. 9a (emphasis supplied). The detailed allegations are however that defendants did not so design the portfolios in this manner, but designed them to maximize the impact of interest rate charges (App. 25a). Nowhere in either brief does either defendant dare touch this flat-out misrepresentation. Why?

Because no amount of cautionary language can sterilize an outright misrepresentation of historical fact (Pet. at 15).

Plaintiffs alleged that defendants did not design the initial composition of the Trusts' portfolios, or managed them thereafter in even an attempt to minimize the impact of changes in interest rates on the net asset value. The record evidence was uniform that the investments had been made as a one-way bet on the course of interest rates that, when lost, predictably would and actually did lead to the destruction of much of the capital invested.[2]

Defendants would misdirect to other prospectus statements that they would merely "attempt" to succeed. If they had attempted and failed to do what they had represented, there would be no case. The case properly lies because defendants did not design the portfolios in the manner represented (App. 24a). The chief judge got it right in his dissent; the majority did not.

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[2] Respondents Hyperion Capital Management, Inc., *et al.*, offer a footnote fudge (n.12) in the form of the contention that the Trusts purchased the instruments they said they would. The chief judge disposed of much of this in his dissent. App. 23a-27a. The short of it is that different subsets of the same instruments will react differently to interest rate changes. The offering materials did not provide enough information for anyone -- even the sophisticated -- to calculate the interest rate sensitivity of what actually was purchased. If it had, the complexity of the analysis is additional reason why the representations must be accurate, and the risks identified tailored to the actual risks.

2. Defendants did not, in their prospectuses, in their briefs, or anywhere else, ever inform, either explicitly, implicitly, or otherwise, that, instead of having designed the composition of the trust portfolios and managed them in an attempt to minimize the impact of changes in interest rates on the net asset value, defendants determined to make a speculative wager on the course of interest rates.

The majority itself acknowledged "that the prospectuses contain[ed] no specific statement that there was a bias in favor of rising interest rates". App. 14a. Nor did it identify any disclosures that so much as whispered that the capital would be invested speculatively, and that by so doing, would be placed at great risk. The second circuit also acknowledged that whatever was disclosed was itself vague -- it did not state whether changes in interest rates could reduce net asset value, much less identify the entirely predictable but undisclosed risk that declines in interest rates would destroy net asset value. App. 13a-14a. To bolster its decision the court relied on what had been disclosed "implicitly", and then permitted these possible implicit remarks to trump express misrepresentations. App. 14a.

That the prospectuses spoke of risks of one kind or another but other than those linked to the actual investment product should be, and seven other circuits, as well as the second circuit's own chief judge agree, of no protective, legal moment. Risk disclosures must be tailored to the true nature of the investment being sold, and the true nature of the risks associated with it. (Pet. at Point I, *passim*.) One can not, by way of illustrative near-fetched example, advertise for sale a

fund designed to acquire long-term United States Treasury instruments, and expect that associated risk disclaimers will do the job where the fund managers *had already designed* a portfolio comprised of penny stocks. No other circuit tolerates the notion that caution, much less inaccurate or incomplete caution, completely unsuited to the actual investment, is a satisfactory substitute for the truth, especially in respect of historical data (Pet. at 15.) The chief judge of the second circuit rejected the majority's anathematical proposition. To sustain the decision below is to open wide the door to the issuance of securities without the need for any meaningful disclosure. Thousands of people lost hundreds of millions of dollars in the respondent trusts. Is that not enough? How much more harm need be caused? Why should the law be contorted to insulate those who induce investments by the making of plainly false statements?

II. THE SECOND CIRCUIT DID IMPROPERLY ENGAGE IN FACT SPECULATION ON A 12(b)(6) MOTION IN VIOLATION OF PLAINTIFF'S SEVENTH AMENDMENT RIGHTS.

No one quarrels with the notion that there are circumstances under which a court may dismiss a claim at the pleading stage because all reasonable minds would agree concerning the significance of the facts asserted. That is not what happened here. To repeat, what distinguishes *Olkey*, and what makes the decision potentially devastating to securities fraud plaintiffs, is the court's willingness to speculate what "must have been" or "should have been" in the mind of

investors based on its own reading of prospectuses and related materials. Pet. at 18-19. Respondents Hyperion 1997 Term Trust, Inc., *et al.*, would elide this point by claiming that plaintiff does not have a right to a jury unless he states a claim on the face of the pleading (p. 18). The argument is bootstrap. The proposition is better stated this way. Given the fact-driven nature of the allegations, it is for a jury to determine their merits. Or this way. If the face of the pleading, drawing inferences in its favor, states a cause, plaintiff is entitled to a jury trial, or at least discovery.

The court's predicate for its belief in its fact-finding entitlement is plainly irrational. The "finding" that dismissal was warranted because "a reasonable investor could have found the promise of moderate returns attractive despite the risk of substantial losses . . .", Pet. 18a, is self-refuting. Reasonable people do not assume great risks for small returns. If they do, it would be aberrant, and not a foundation for a 12(b) dismissal. Chief Judge Newman recognized this truth throughout his dissent (App. 22a-23a). As he put it, "Not only is the Court's assumption about purchasers of fixed-income securities unsupported by any evidence, it is also highly likely to be incorrect." Under these circumstances, only one conclusion is permissible. In this decision the second circuit has deprived thousands of injured persons of their Seventh Amendment rights.[3]

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[3] In the brief filed by Hyperion Capital Management Inc. *et al*, defendants contend that this issue is not ripe for presentation because it had been raised for the first time on the rehearing petition below. Unlike the cases cited by defendants, this is

(continued...)

CONCLUSION

The decision of the court of appeals creates important conflict with the law of other circuits on an issue of national significance. The decision of the court of appeals below has destroyed the constitutional rights of thousands of class members. The petition for a writ of certiorari should be granted.

Dated: May 14, 1997

Respectfully submitted,

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[3](...continued)
not an issue that wended its way through a state court system, it is an issue that necessarily was raised in the appeal from the dismissal in the district court pursuant to 12(b)(6), and if not, could not have been otherwise raised earlier because it necessarily responded to the decision of the second circuit itself.